Middlefield Canadian Income

MCT: stable income from an overlooked equity market...

Update
22 August 2023

Overview

Middlefield Canadian Income (MCT) offers investors exposure to Canada, an equity market often overlooked by UK investors despite the historical relationship between the two countries. Canada is a G7 economy adjacent to the US but with a very different sector make-up to its equity market, and a much stronger equity income culture, which is reflected in MCT's yield of c.5.0% . The largest sectors in MCT's benchmark are financials, utilities, energy, and pipelines, which gives a strong sense of the difference compared to its tech-heavy southern neighbour. MCT has exposure to all these sectors, but its most significant overweight has consistently been to Canadian REITs, with a c. 24% exposure being about four times the benchmark. Manager Dean Orrico says that REITs are trading at average discounts only seen twice before during this century and that underlying earnings have been stable or rising even as discounts have widened.

Dean has managed the trust since its launch in 2006 together with his colleague Rob Lauzon. He has been with Middlefield since 1996 and has over 35 years of investment experience. He also manages a specialist fund of REITs and is president and CEO of Middlefield Group.

MCT has a track record of stable dividends and following a post-pandemic recovery in underlying earnings, the trust's board slightly increased the dividend in 2023, with full dividend cover now restored, giving a current yield of c. 5.0% . The trust is normally geared in the range of 15-20%, and gearing currently sits in the middle of this range. The discount is c. 14%, which is a little wider than the five-year average of 13%.

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Analyst's View

MCT is sticking to its guns with its allocation to Canadian REITs for reasons that will sound familiar to UK investors. We explore this in the **Portfolio section**, but essentially, constrained supply and strong occupier demand have been temporarily overwhelmed by rising interest rates, leading to REITs trading on historically wide discounts. So just like in the UK, investors will need to be patient, as there's unlikely to be a proverbial bell rung at the exact inflection point where REIT share prices start to perform. In the meantime, dividends have been held or increased. At 24% of MCT's portfolio, we think a recovery in REIT prices is the most likely source of outperformance and discount narrowing in the near term.

MCT is also exposed to some other strong themes, notably energy, where Canada is a major exporter, with new infrastructure coming into service to accelerate that. Dean says that Canadian producers are very focussed on production efficiency, which has translated to strong dividend growth. Additionally, Canadian banks have maintained their reputation for stability, even during the recent mini-banking crisis in the US, and this remains an important sector for MCT, even at a slightly underweight position.

As we discuss in the **Dividend section**, MCT's dividend increased this year as underlying earnings bounced back from the pandemic years. The yield is currently c.5.0%, which compares to c.3.7% on ten-year Canadian government bonds, and 3.5% .for the Canadian equity market, illustrating MCT's key attraction as an equity income trust.

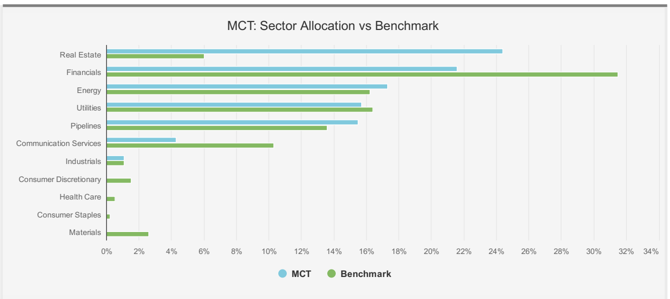
BULL
Strong recovery potential from large overweight in REITs
Exposure to an overlooked G7 economy with strong long-term growth trends
High dividend yield compared to local equities and bonds

BEAR
Relatively high gearing for an equity income trust
Large exposure to fossil fuels may not suit some investors
Portfolio concentrated three main sectors, albeit very different to neighbouring US market

Portfolio

The chart below provides a good summary of the make-up of Canada's equity market, and how Middlefield Canadian Income's (MCT) managers build the portfolio around it. All of the principal sectors of the market, financials, energy (including pipelines), and utilities, are represented in the MCT portfolio, but the most eye-catching active position is in the Canadian real estate, or REIT, sector. Dean believes that these sectors all have secular growth trends driven in part by constrained supply, but also, in the case of energy, by the need for transitional fuels like gas. Canada is a major exporter of gas and has been a major beneficiary of Europe's efforts to wean itself off Russian gas supplies.

Fig.1: Sector Allocation



Source: Middlefield, as at 31/07/2023

Real estate

Canadian REITs' core attributes align with those that Dean and the team seek to meet MCT's objectives, notably relatively high dividends, and stable earnings with a long-term correlation to inflation, so this has long been a feature of the portfolio. In the shorter term, Dean's view is that there is a great deal of value in the REIT sector, with many trading at significant discounts to net asset value, while at the same time seeing good operating results. Dean says that on average, REITs are trading at a 26% discount, a level that has only been seen twice previously over the last 20 years: during the pandemic and the financial crisis. In both previous cases, discounts this wide did not last long, and the sector is already seeing some M&A activity, indicating that real estate investors see value in Canadian REITs.

One of the most important long-term drivers of real estate in Canada is supply constraint. Although Canada is a big country, over 80% of the population live in cities and each of these has its supply constraints. Dean gives the example of the greater Toronto area (GTA), which is bounded by the largest greenbelt in the world to the north, and by lakes to the south, putting practical limitations on real estate development. Add to that Canada's immigration system, which saw 500,000 new permanent and the same number again of temporary visas granted last year. This is in the context of a population of 40m, and therefore there is significant population growth always putting pressure on the supply of real estate. Dean also says that despite the population growth there is a shortage of skilled construction workers, putting a further limit on new supply.

Dean has positioned the real estate part of the portfolio in industrial and logistics, retail, and residential. These sectors are undergoing positive trends that will be familiar to UK investors, with demand for industrial and logistics assets being very strong as the economy continues to develop its hybrid online and physical model, and supply chain management evolves from a just-in-time efficiency model to a more robust just-in-case model, taking lessons from the pandemic, where supply chain issues were a major issue for all developed economies, including Canada. Dean notes that there is no exposure to retail malls, which remains a problem area, with the focus on retail sites anchored by 'essentials' tenants such as Walmart. He highlights that some of these sites, with very large surrounding land allocated to parking, have the potential for further mixed-use development. The portfolio has no exposure to offices, which Dean sees as another problem area, with post-pandemic working practices still evolving and increasingly tough environmental and efficiency standards making old offices expensive to upgrade. Again, these are trends that UK investors will be familiar with.

Dean also gives an 'honourable mention' to senior living REITs such as Chartwell Retirement Residences. Although immigration means Canada has a growing population, it still has an ageing population, and Chartwell, for example, is seeing some of the costs and challenges of the pandemic now falling away, and profitability is improving.

Energy

Energy remains a significant part of the MCT portfolio, with exposure of c.30% split roughly equally between producers and pipelines. This exposure is in line with the benchmark: Canada is very rich in energy and is a net exporter of electricity, gas, and oil. Canada's electricity grid is almost entirely powered by renewable sources, with hydropower the predominant source, but Canada has an estimated 300 years' supply of gas. Gas is seen as an important transitional fuel that is replacing more polluting sources of energy. Canada is in the commission phase of its first liquified natural gas (LNG) export terminal in British Colombia for exporting LNG to Asia and Dean says that four further terminals are at various stages of development, to be commissioned in the next few years. Clearly, Europe is already well-progressed with its pivot away from Russian gas, and Canada has been a major beneficiary. Canadian gas producers have increasingly focussed on production efficiency rather than exploration, and Dean cites the example of Canadian Natural Resources, c.5% of MCT's portfolio, which pays a dividend that has grown above 20% a year over 20 years.

Just as in real estate, supply constraint is an important driver of returns for the pipeline sector, which although classified in the allocation chart above separately, is really a sub-set of energy relating to pipeline infrastructure. Canada remains one of the US's most important sources of energy, and new pipelines are incredibly difficult to take through planning and build, so there are strong incentives for existing operators to focus on operational efficiency and to pay dividends to shareholders, again factors that align very well with MCTs core objectives.

Financials

The third leg of MCT's long-term exposure is financials. Canada has a very different banking sector from the highly fragmented US, with six banks. Although these banks generally do have US-based businesses, they are much better capitalised and have followed a relatively conservative lending strategy. Dean notes that Canadian banks have been able to increase dividends, which is not always the case for banks in other markets, where regulatory capital is thinner and banks are less able to increase payouts as a result.

Utilities

MCT also maintains long-term exposure to Canadian utilities. As noted above, over 80% of Canada's electricity is generated from renewable sources, and it is one of the world's largest exporters of electricity. Utilities, therefore, offer both regulated revenues and growth opportunities through investment in expanding sources of renewable energy for export. MCT owns, for example, the CAD 27bn market cap Brookfield Renewable Partners, which is backed by contracted cashflows but also able to grow in partnership with its parent Brookfield both organically and via M&A.

Overall, we think MCTs portfolio represents the strongest sectors of the Canadian economy, with good long-term growth prospects backed up in some cases by supply constraints, and in real estate in particular by low valuations that have only been experienced very few times in the past.

Gearing

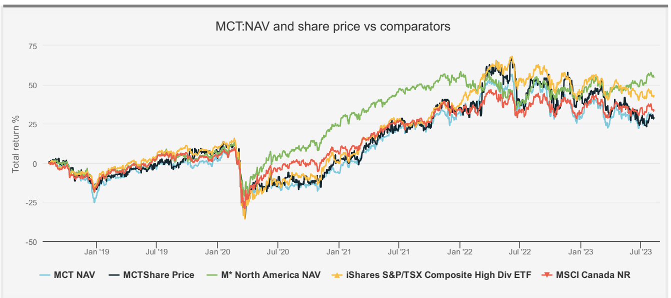
MCT is able to borrow up to 25% of net assets at the time of borrowing, but in the normal course of business, gearing is expected to be between 0% and 20%. Over 2023, gearing has remained fairly constant in the range of 15-17%, following a period in 2022 when gearing was reduced slightly as markets became more volatile.

MCT gears using short-term flexible debt and has a facility with RBC for the lower of CAD 65 million or 25% of net assets. The team's view is that flexibility is desirable when it comes to gearing.

Performance

Over the last five years, MCT's NAV total return has annualised at c.6.3%, which compares to the S&P/TSX Composite Index's 8.3%, and the benchmark, the S&P/TSX Composite High Dividend Index, which has annualised at 9.1%. As we discuss in the **Portfolio section**, MCT's overweight exposure to REITs has held performance back as interest rates have risen, given this is a classic interest rate-sensitive sector, but this also may be the key to future performance as this sector's historically low valuation could improve when the interest rate cycle turns.

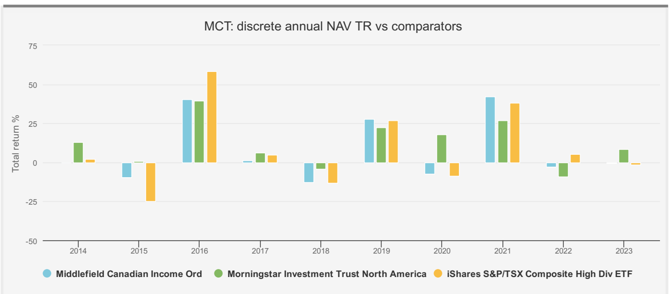
Fig.2: Five-Year Performance



Source: Morningstar,as at 10/08/2023
Past performance is not a reliable indicator of future results.

The chart below breaks down performance into discrete calendar years. It illustrates that MCT sometimes gets left behind in strong rising markets, which we would expect given its low exposure to higher-growth sectors, but it also tends to hold its ground when markets are more difficult. In 2021, MCT experienced very strong absolute and relative performance as its position in REITs performed very well as the impact of the pandemic began to abate. Rising interest rates have subsequently set that sector back, but it's an interesting illustration of how this sector can outperform in the right circumstances.

Fig.3: Discrete Annual Performance

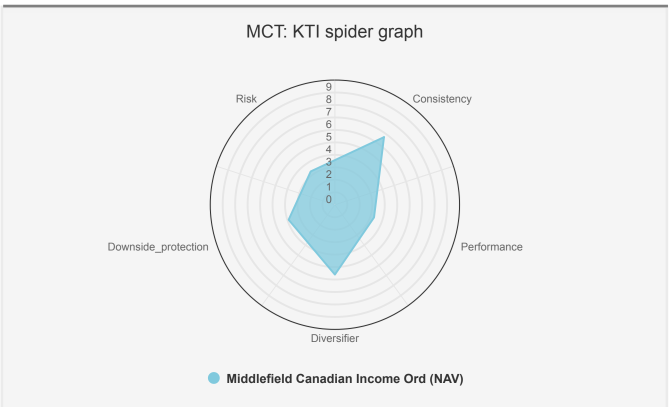


Source: Morningstar, as at 10/08/2023
Past performance is not a reliable indicator of future results.

In our proprietary spider chart below, we show how MCT has performed versus an expanded peer group of all AIC North America and North America Smaller Companies trusts over the past five years in some key categories. Each category is scored out of ten based on rolling 12-month returns over the last five years, and scores are normalised to the peer group. As such this data reflects the performance characteristics investors would have experienced over the last five years.

The analysis highlights MCT's attributes of consistency and diversification, given that many in the peer group will have had much greater exposure to technology and to the ups and downs of growth investing more generally over the last five years. Like many others, MCT's recent performance has been muted, albeit in the context of muted performance for the benchmark as well, but there are clear pathways to improving performance, which we discuss in the **Portfolio section**.

Fig.4: KTI Spider Chart



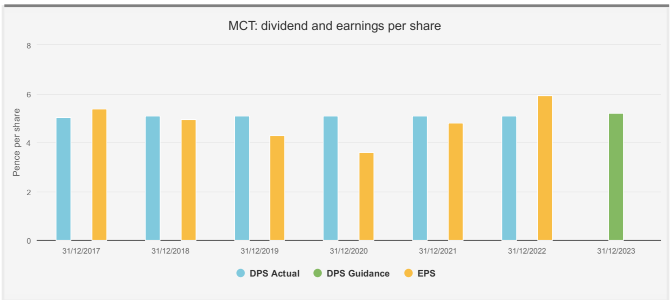
Source: Kepler Calculations
Past performance is not a reliable indicator of future results.

Dividend

MCT pays quarterly dividends in equal instalments in January, April, July, and October. The current yield is c. 5.0% . As the chart below shows, underlying earnings dipped in the pandemic, with MCT's reserves used to maintain the dividend, but since then earnings have been on an improving path and at the end of 2022, MCT's board issued guidance that the total dividend target for 2023 would be increased slightly from 5.1p to 5.2p, with the first three quarterly dividends of 1.3p already paid at the time of writing.

MCT charges two-thirds of its overall costs to revenue, which is conservative for an equity income trust, and means there is scope to adjust the ratio if in future the balance of expected returns between income and capital changes. Although MCT is a UK-domiciled investment trust, it is a cell of a Jersey Protected Cell Company. The concept of revenue reserves differs slightly under the accounting standards used by MCT, and the most analogous figure, retained earnings, totals c.£86m compared to a total cost of dividends for the 2022 financial year of c.£5.4m, meaning that MCT is well-placed to utilise reserves in future years if there is a shortfall.

Fig.5: Dividend And Earnings Per Share



Source: Middlefield
Past performance is not a reliable indicator of future results.

Management

MCT's investment adviser is Middlefield International, the UK-regulated entity of Middlefield Group. Middlefield Group was founded in 1979 and manages mutual funds, closed-ended funds, exchange-traded funds, real estate, and venture capital funds. Middlefield's core expertise lies in real estate, healthcare, equity income securities, natural resources, and sustainable investment. Middlefield has approximately 50 employees based in Toronto, Calgary, San Francisco, and London.

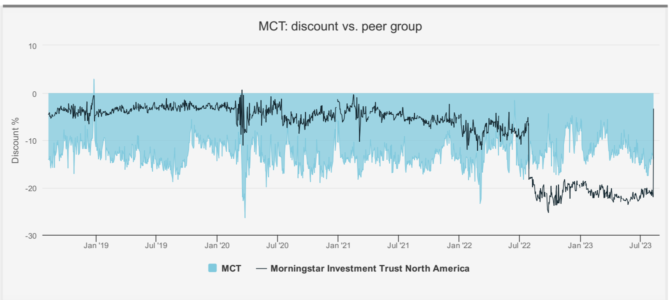
MCT is co-managed by Dean Orrico and Rob Lauzon, who work within Middlefield's team of nine investment professionals.

Dean Orrico is the president and CEO of Middlefield Group. Dean has over 35 years of investment experience and joined Middlefield in 1996. Dean co-manages several of Middlefield's other strategies, serving as lead manager of Middlefield's real estate strategies while also being involved in the management of the company's healthcare and income strategies. Dean also manages Middlefield's dedicated REIT fund, thus adding to his knowledge and expertise in this important sector for MCT.

Discount

MCT's current discount of c. 14% is just a little wider than the five-year average of c.13%. The chart below plots MCT's discount against the Morningstar North America peer group, which has recently seen the addition of Pershing Square Holdings (PSH), which trades at over a 30% discount and has a significant distorting effect on the average. Without the effect of PSH the peer group average is c.10%, albeit there is a wide variation within the remaining group that makes the average somewhat academic.

Fig.6: Five-Year Discount



Source: Morningstar, as at 10/08/2023

The most likely catalyst for MCT's discount to narrow is, in our view, performance related, and given the trust's active bet on Canadian REITs, this is a potential source of outperformance, which would likely coincide with an end to rising rates, which would also have the effect of highlighting the attractive dividend yield.

Charges

MCT's ongoing charges figure (OCF) at the last financial year end was 1.34% compared to 1.24% for the previous financial year. This compares to an average OCF of 0.85% for the AIC North American sector (excluding PSH, which has an OCF of nearly 3%, but is not really comparable), according to JPMorgan Cazenove data.

MCT's management fee is 0.7% of net assets. Management fees are specifically charged 60% to revenue and 40% to capital, although as we note in the **Dividend section**, overall costs are split two-thirds to revenue and one-third to capital.

The Reduction in Yield (RIY) figure on the most recent KID is 2.27% compared to an average of 1.24% for the sector excluding PSH (Source: JPMorgan Cazenove), although we note that methodologies may vary.

ESG

MCT has an 'average' ESG rating from Morningstar within the open- and closed-ended North American sectors. MCT screens out tobacco and arms companies from its portfolio, and its full ESG policy can be found **here**. Typically MCT is overweight the energy sector, largely in fossil fuel related areas, which will score lower in ESG screens, albeit Dean and the team's view is that many of their energy holdings are part of the energy transition, and the decision to own them has been taken within the framework of an integrated ESG policy. Conversely, MCT is typically overweight real estate, where specific ESG issues are somewhat more clear cut than other sectors, e.g. energy efficiency, and are easier to analyse and engage on.

Middlefield is an associate member of Canada's Responsible Investment Association (RIA). The RIA is a national, membership-based organisation that is committed to advancing responsible investment, meaning the incorporation of ESG factors into the selection and management of investments.

ESG considerations are integrated into Middlefield's investment decision-making and monitoring process. Middlefield's chair of ESG is considered one of the foremost experts on governance and ESG in Canada and also sits on the board of Canada's RIA and is a member of the global stewardship committee of the International Corporate Governance Network (ICGN).

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